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Dow Theory Letters

"The Market as Interpreted under the Dow Theory"

RICHARD RUSSELL
125 East 93rd Street
New York City 28

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THE THEORY'S USEFULNESS The Dow Theory admittedly is a useless study for the "in-and-out" trader. The scalper -- the man who is trying to grab a few points and run -- is actually attempting to beat the professional floor trader at his own game. In the end, this is a hopeless task, for the cards are stacked against the scalper much as they are stacked against a bettor at the race track. The professional pays no commissions, he has the "feel" of the market hour by hour, he can, if he wishes, reverse his positions ten times in a day. Over a period of years, the amateur who "plays" the daily trend will lose his money to the professional, and there is no market system in the world that can help him.

When trading on the secondary or primary swings, however, the student of the market is in the same league with the professional. In fact, the man who is removed from the Wall Street rumor mill often has a better chance of showing long-range profits than his New York counterpart. I suspect that the twin practices of tape-watching and buying on "inside information" have been far more conducive to losses than profits.

Followers of Dow's Theory know that its usefulness can only be weighed against relatively important market swings. Many readers of these Letters are individuals who (by their own admission) do not own a share of stock; they are interested in long-range economic prediction which will affect their personal course of action. Others are businessmen who like to keep an eye on the primary and secondary predictions of the Theory. They set their business sails in harmony with the stock market barometer. Finally there are the investors and traders who have learned that the market is its own best forecaster. They have searched (as have I) for an infallible system. Not having found one, they have philosophically settled for the best obtainable.

Dow's Theory has endured the test of sixty-two years of economic expansions and contractions. That the Theory has a large and serious following today is, perhaps, the finest testimony to its usefulness. Nevertheless, it is well to put a system on trial from time to time. For this reason, a review of recent predictions is in order.

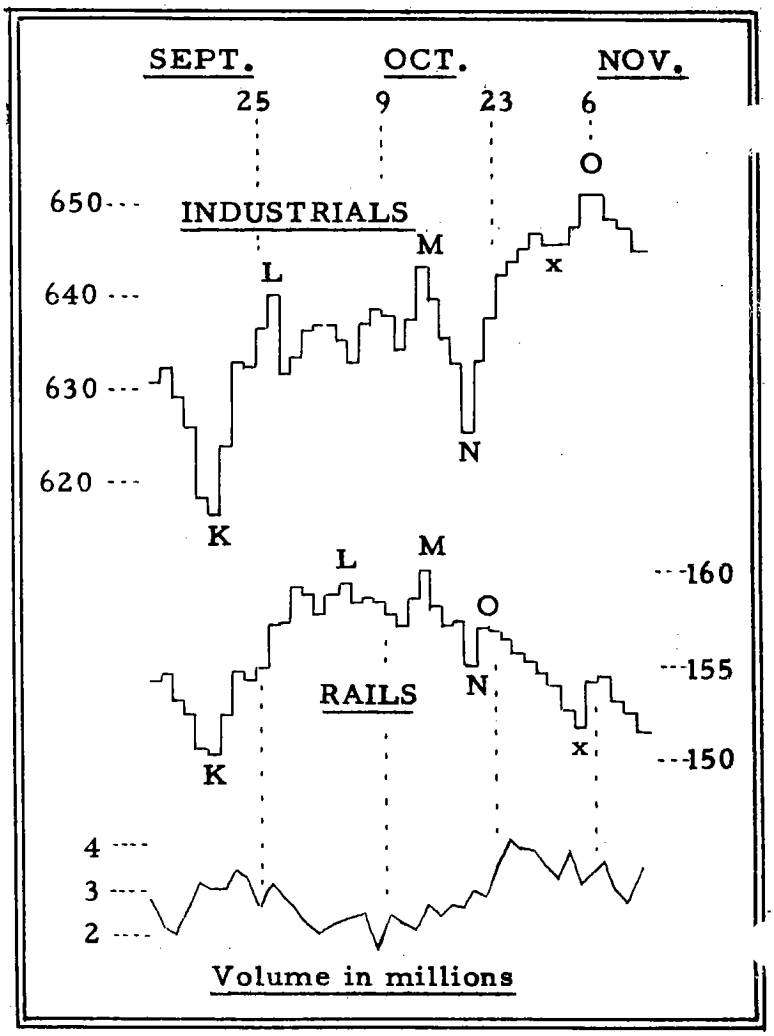
In late July, the Theory signaled "caution" for the businessman and investor. The low volume industrial advance and the refusal of the rails to confirm this advance came amid universal bullishness, yet the succeeding months of August and September gave birth to the first secondary reaction since 1957. On August 10 (see Letter 75) the market warned of "danger ahead" as previous decline lows were violated on heavy volume. Although the nation was unaware of it, the market barometer was predicting the first serious trouble in two years. The nature of that trouble became apparent in later weeks -- tightening money, history's longest steel strike, intensified foreign competition, declining farm income and the shadow of a rail strike. Taken together, these events spelled the first interruption of a great boom that was held to be "in the bag" for 1959 and 1960.

Following the reaction, on September 25 (Letter 79), I outlined the conditions that would signal a major reversal of the primary trend -- namely, a violation of the September lows on high volume. Such a bear signal would imply that the stock market and the country were destined to face problems far greater than anything seen over the last ten years.

By steadfastly holding above the September lows, however, the market has said that the primary trend (so far) continues up. But as long as one or both averages fluctuate between the July-August highs (industrials 678.10, rails 173.56) and the September lows (industrials 616.45, rails 150.28) the market will be reserving final judgment. If the averages work higher in a series of ascending zig-zags, if volume tends to expand with higher prices, then the market will be advising Dow Theorists to remain cautiously hopeful. Such action would imply an eventual attempt at bettering the July-August highs (with a resultant resumption of the boom).

Conversely, one or more of the following could imply that the trouble is not yet over, and that the market will again "test" the September lows: (1) excessive volume with little or no upside progress ("churning"), (2) one average declining persistently while the other advances (divergence), (3) one average bettering a previous peak or going to a new high while the other average refuses to confirm, (4) following a decline, an advance commences with one or both averages refusing to better their preceding minor highs; then a second decline with both averages violating preceding minor lows on increasing volume.

PRICE MOVEMENTS. History shows that every market movement, whether minor, secondary or primary, is subject to the normal correction of 1/3 to 2/3. The secondary reaction of July-September, 1959, served to correct 24% of the entire 1957-59 industrial advance, 30% of the total advance in rails. Following this reaction (which ended at K on chart), industrials advanced to a new recovery high at point O. This move retraced 55% of the losses suffered by industrials during the reaction. Rails rallied to M, and this advance served to retrace 41% of their reaction losses.



It is obvious that rails have been the weaker average; their reaction losses were heavier, and their recovery gains slighter. The question which now faces Dow Theorists is whether the rail action is implying weakness in the price structure or whether the superior industrial action is suggesting strength. An eventual rail bettering of the preceding high at M (159.99) would confirm the strength in industrials. Conversely, an industrial decline violating N (625.59) would confirm the weakness in rails. The Dow Theory places no time limit on confirmation. For this reason, if industrials continue to

rally and rails merely move in the same direction (with volume expanding) we may infer that there is a good chance of a rail confirmation. By the same token, if rails continue to decline, and industrials follow them down (on expanding volume) the picture will appear decidedly less pleasant.

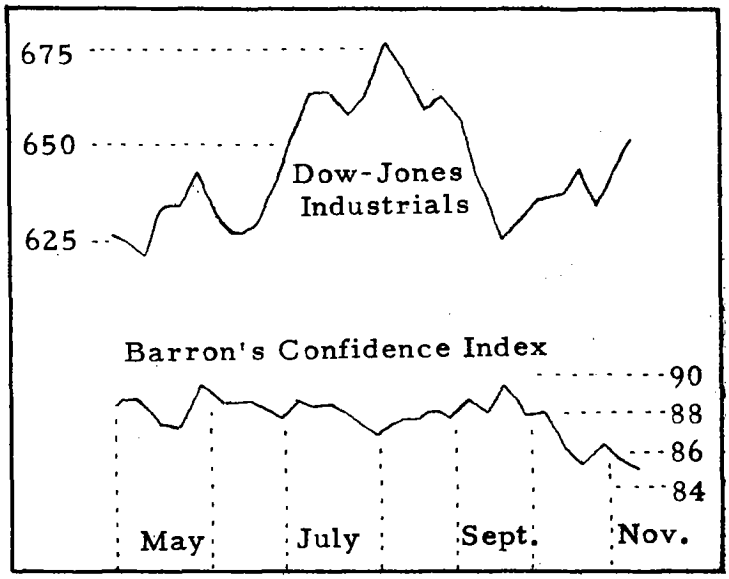
I might also add that if rails violate their low point at K (and in so doing give one half of a bear signal), the penetration will be meaningless. A penetration of one average unaccompanied by the other has absolutely no significance under Dow Theory, and those who have traded on such indications in the past have had cause to regret it.

The only impressive action in many weeks came on November 6. Here, rails and industrials finally rallied "in gear" (in the same direction), and volume expanded. The next trading day (Monday, November 9) witnessed the Taft-Hartley decision, an explosive one hour celebration and a sell-off which took both averages back to Friday's close. As mentioned in Letter 83, a lot of fuel was again expended under an engine which was standing still ("churning"). November 11 and 12 saw lower markets on declining volume. Both days had this observer blinking as the glamour stocks spurted and such investment grade issues as Ford, G. M. and U. S. Steel sank lower.

CONCLUSION. Until proved otherwise, the primary trend of the market is taken to be up. It will remain up as long as one or both averages hold above the K lows. The secondary trend turned down at N. It will not turn up in the full sense until rails better their preceding high at M (159.99). A series of upward zig-zags in both averages would suggest, however, that the secondary trend was in the process of turning up. If both averages can better their preceding little peaks the minor trend will be up.

CONFIDENCE INDEX (C. I.) I have received many questions regarding Barron's Confidence Index (see Barron's article by J. E. Granville, September 7, 1959). This Index is merely the ratio between the average yield on Barron's highest grade bonds and the Dow Jones 40 bonds. When investors are optimistic they tend to buy lower grade debt with correspondingly higher yields (as represented by the D-J 40 bonds) and the C. I. rises. When investors turn cautious they upgrade their bond portfolios (as represented by Barron's 10 high grade bonds) and the C. I. declines.

The C. I. hit a high of 89.6 on the last week of May (see chart), then declined in a shallow movement only to rise to 89.7 in September. Following the September peak, however, the Index has dropped precipitously, hitting a new 1959 low of 85.2 on the week of November 2-6. Since, historically, there is about a two month lag between the C. I. and the stock market, the C. I. is now calling for a sharp market drop starting around the middle to the end of November (or about two months after the September peak).

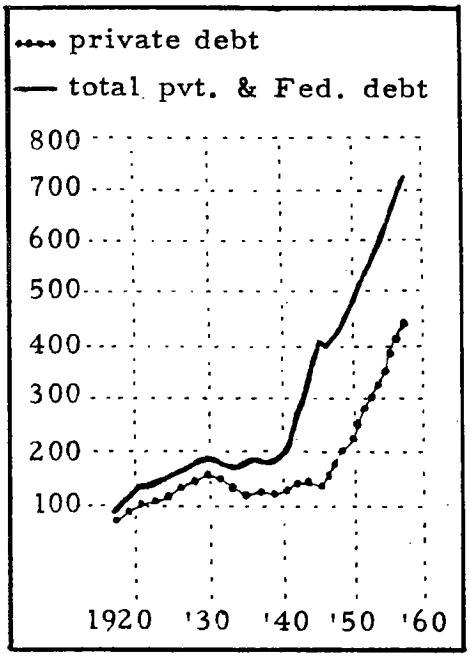


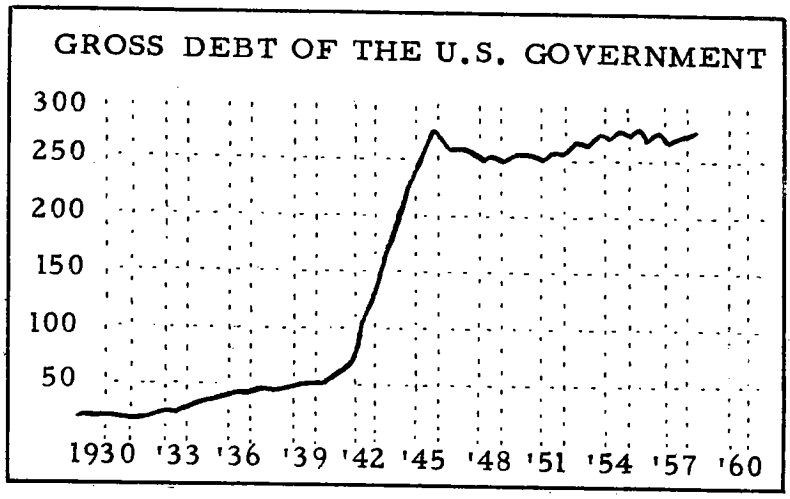
I recently spoke to Mr. Granville regarding the 89.7 high of September. He told me that he does not consider it a valid new high because of the minor (one-tenth point) penetration and because this high was immediately followed by a sharp reversal. For those who wish to check the validity of the C.I., it is now saying that the market will be in for trouble before this month is out.

PERSONAL OPINION. In our present "semi-managed" economy, the law of supply-and-demand is often impeded, yet no government has ever been able to eliminate this natural law. Unfortunately, human fear cannot be legislated away, nor can human desires be removed by Federal edict. Without wishing to pass judgment on the current state of affairs, it seems to me that the managed economy tends to produce longer primary swings, higher bull markets, bigger reactions and perhaps (time will tell) greater bear markets.

Whereas bull markets used to last a few years and bear markets about half that time, we are currently in a bull market which has been in effect for over a decade. During that period, there have been many upward, but remarkably few downward adjustments in the economy. Herein lies the unknown side of the coin. The charts below, in fact, portray one of the upward adjustments which has not yet been tested by a full-fledged bear market. Booms are built on confidence and credit; bear markets are created by the loss of both.

(The above written the morning of November 12, 1959)





(Following written November 12, after the close). On increasing volume (3.6 million shares), both averages continued down, this time violating their minor lows at point x on chart. The minor and secondary trends are now both pointing down. This places the burden of proof on the bulls, and I continue to suggest "no purchases" at this time.